IN THE

Supreme Court of the United States

No. 287.

October Term, 1946.

J. ROBERT BAZLEY,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

REPLY BRIEF FOR PETITIONER.

HENRY S. DRINKER,
FREDERICK E. S. MORRISON,
CALVIN H. RANKIN,
Attorneys for the Petitioner.

DRINKER BIDDLE & REATH,
1929 Walnut Street,
Philadelphia 2, Pa.

Law Printing Co., 236 Chestnut St., Phila. 6, Pa.

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REPLY BRIEF ON BEHALF OF PETITIONER.

In his present brief, the Commissioner has so shifted his position on the principal point in the case from that heretofore advanced by him, that a short reply brief is necessary.

Heretofore the main question has always been whether, as the Tax Court held, *Gregory v. Helvering*, 293 U. S. 465, decided that a corporate reorganization, in order to be tax free, must be one conducted for a "corporate business purpose" of the corporation as distinguished from serving a proper business purpose of the shareholders.

Realizing, perhaps, that there could be no more "clear-cut question of law," than that involving a construction by the Tax Court of this Court's decision, the Commissioner's present brief would have it appear that the question is not the correctness of the Tax Court's construction of the *Gregory* case, but is the validity of the Treasury Regulation [1] (adopted in 1934 to put into effect the *Gregory* decision by the Circuit Court of Appeals for the Second

(1) Articles 112 (g)-1 and 112 (g)-2 of Treasury Regulations 86, as embodied in Sections 19.112 (g)-1 and 19.112 (g)-2 of Treasury Regulations 103.

Circuit), two isolated clauses of which are now quoted and relied on by the Commissioner. He now contends that for this Court to reverse the Court below and the Tax Court would involve a holding that these Treasury Regulations were "invalid." The *Gregory* decision is now relied on, not as controlling this case but merely as presenting "a similar restriction upon the scope of the reorganization provisions by this Court" (Commissioner's brief, p. 14). *Dobson v. Commissioner*, 320 U. S. 489, is injected in support of a supposed finding by the Tax Court that the present recapitalization was not "undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization" as stated in the Regulation.

Although the Regulation was cited by the Commissioner in his brief in the Tax Court, that Court in its opinion made no reference whatever to the Regulation.

While in his brief in the Circuit Court of Appeals, the Commissioner cited the Regulation in support of the Tax Court's construction of the *Gregory* decision, the question there presented was as stated in Judge O'Connell's first opinion (Rec. 109-110):

> "The issue here is sharply defined: The Commissioner maintains that, absent a legitimate corporate business purpose, there can be no tax free reorganizational transaction, under the doctrine of Gregory v. Helvering, 293 U. S. 465 (1935). Petitioner, however, argues that the *Gregory* decision is inapplicable where there exists a legitimate business purpose of the *stockholders* for the reorganization ('Reasons other than tax avoidance', to use the petitioner's phrase)."

What the Tax Court found was that there "was no legitimate purpose of the corporate business of J. Robert Bazley, Inc., in the issuance and distribution to the stockholders of $400,000 in debenture bonds" (Rec. 95a).

Obviously this finding is relevant only provided the Tax Court was right in its construction of the *Gregory*

decision in requiring a "legitimate purpose of the corporation's business," as distinguished from a purpose, other than tax avoidance, for the benefit of the stockholders.

As stated by the Commissioner on page 5 of his present brief "The reasons for the adoption of the plan" found by the Tax Court were the four specified, none of which was tax avoidance. The Commissioner on page 33 says:

> "We are not here contending that the plan of recapitalization should be disregarded, or that the securities issued in pursuance of it are unreal or not valid in accordance with their tenor."

Furthermore, the Regulations now relied on, from which the Commissioner and the Court below quote but two isolated phrases, do not, read as a whole, support the distinction between a corporate and a stockholder purpose.

As stated above, these Regulations were adopted to implement the *Gregory* decision. For the purposes of the present question, the significant portions are as follows:

> Sec. 19.112(a)-1 Sales or Exchanges.
>
> * * * The exchange must be *germane to*, and a necessary incident of, *the* **investment** *or enterprise in hand.*
>
> Sec. 19.112(g)-1. Purpose and scope of exception of reorganization exchanges.—*Purpose:* * * * The purpose of the reorganization provisions * * * is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures, * * * as are required by business exigencies, and which effect only a readjustment of continuing interests in property under modified corporate forms. Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form, and a continuity of interest therein on the part of those persons who were

the owners of the enterprise prior to the reorganization.

* * *

* * * Such transaction and such acts must be an ordinary and necessary incident of the conduct of the enterprise and must provide for a continuation of the enterprise. A scheme which involves an abrupt departure from normal reorganization procedure, devised and adopted with reference to a transaction on which the imposition of the tax is imminent, is not a plan of reorganization.

Sec. 19.112(g)-2. Definition of terms.—* * *

* * *

A "recapitalization," and therefore a reorganization, takes place if, for example—

* * *

(3) A corporation issues preferred stock, previously authorized but unissued, for outstanding common stock; or

* * *

Moreover, the transaction, or series of transactions, embraced in a plan of reorganization must not only come within the specific language of section 112(g)(1), *but the readjustments* involved in the exchanges effected in the consummation thereof *must be undertaken for reasons germane to the continuance* of the business of a corporation a party to the reorganization. Section 112(g)(1) contemplates genuine corporate reorganizations which are designed to effect a readjustment of continuing interests under modified corporate forms. (Emphasis supplied.)

These provisions obviously do not require that an exchange, in order to be tax free, shall be in furtherance of some *corporate* objective as distinguished from one for the primary benefit of the stockholders. Such a distinction between an advantage to the corporation and to the stock-

holders is not deducible therefrom, particularly in view of the passage at the beginning under Regulation Sec. 19.112(a)-1 providing that the exchange must be germane to the **investment or** enterprise in hand.

The Commissioner in his present brief significantly omits all reference to illustration (3) in Sec. 19.112(g)-2 of the Regulations, above quoted, in which it is specifically stated that a tax-free "recapitalization" takes place when a corporation issues preferred stock previously authorized but unissued, for outstanding common stock. The Commissioner does not undertake to explain how this could benefit the corporation as distinguished from the stockholders.

The words "germane to the continuance of the business of" obviously do not mean "for the sole benefit of the corporation as such." What they mean is that the exchange must be one consistent with a continuance of such business, and not a mere temporary expedient "masquerading as a corporate reorganization" and "put to death" immediately after its tax avoiding purpose had been supposedly accomplished.

The illustrations in the Regulations, as well as the passages not quoted by the Commissioner in the body of his brief, or by the Court below in Judge O'Connell's opinion, make the construction now claimed for the word "germane" impossible.

The gist of the Regulations is that under the *Gregory* case, the exchange must be a genuine one, not a sham, and that it must be followed by a continuation of the business, and not the immediate dissolution of the corporation constructed solely to effect a tax-avoiding scheme.

That the present recapitalization was a genuine and permanent one is specifically admitted by the Commissioner.[2] Nor is it disputed[3] that the business of the company is still going on as usual.

(2) "We are not here contending that the plan of recapitalization should be disregarded, or that the securities issued in pursuance of it are unreal or not valid in accordance with their tenor" (p. 33, Commissioner's brief).

(3) Commissioner's brief, bottom of p. 30.

As stated by the Court below (Rec. p. 109 note 3), there is no specific finding in the case at bar, as there is in the *Adams* case argued at the same time, that the tax saving to the corporation by the exchange of interest-bearing debentures for common stock was to the advantage of the corporation as distinguished from the stockholders. This fact, however, was present in the case and is covered by our third "Questions Presented" and "Specification of Errors."

If this Court should sustain the position of the petitioner in the *Adams* case, the Court might, it is submitted, recognize the presence of the point in the case, or, if it deemed proper, send the case back to the Tax Court for a specific finding.

In connection with the supposed infallibility which the Commissioner apparently claims for the legal conclusions of the Tax Court, it is not without significance that on both branches of the case, the present brief for the Commissioner disregards the principal conclusions by the Tax Court.

On the main point the Commissioner now relies primarily, not on the *Gregory* decision, but on the Regulations to which the Tax Court did not once refer.

On the second point, the Tax Court relied on Section 115(g), providing that where a corporation "cancels or redeems its stock" in such a manner as to be "essentially equivalent to a taxable dividend" it will be so considered (Rec. p. 97a note 2). Recognizing, doubtless, that under the stipulation, adopted by the Tax Court, these debentures were issued in part *exchange* for the old stock, the Commissioner now expresses indifference as to whether the debentures are taxable, as the Tax Court held, under Section 115(g) or as he now suggests (Commissioner's brief p. 26) under Section 115(a).

The Commissioner now contends (p. 32), that this case comes under Sec. 112(c)(2), providing that distributions in a reorganization having the effect of a distribution of a tax-

able dividend must be so treated. If, however, because this case lacks a corporate business purpose it is not to be held a reorganization, then Sec. 112(c)(2) by its terms is not applicable. Recognizing this, the Commissioner now falls back on the proposition that 115(a) and (g) must be read "as a gloss" on Sec. 112(c)(1) providing that the gains, if any, to the recipient shall be recognized to the extent of the fair market value of the "other property" received in the exchange. In such case, however, the capital gains provision of Section 117 would be applicable. Also, if it is assumed, as the Commissioner does on the bottom of page 31, that there was here a reorganization, admittedly no tax was due, since no cash was distributed (as it was in the *Bedford* case, 325 U. S. 283), stock having here been "exchanged solely for stock and securities," Section 112(b)(3).

Respectfully submitted,

HENRY S. DRINKER
FREDERICK E. S. MORRISON
CALVIN H. RANKIN
For Petitioner.